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SUBJECT: Supreme Court Clears Expanded VAT Law

Refs: A) Manila 4112  
B) Manila 4528  
C) Manila 2879  
D) Manila 2167

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Summary  
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**11.** (SBU) The Philippine Supreme Court upheld the legality of the Expanded Value Added Tax (EVAT) law, the key element in President Arroyo's revenue-enhancement agenda, boosting the credibility of her economic reform efforts. This measure could reduce debt accumulation and fund increases in social expenditures and infrastructure from the expected 80 billion pesos (\$1.4 billion) in additional revenue in 2006. Financial markets responded positively to the Court's decision. The Government expects political opposition and possibly militant groups to hold street protests opposing the measure. End  
Summary.

**12.** (U) On October 18, the Philippine Supreme Court (SC) upheld with finality its September 1 decision declaring the EVAT law constitutional (Ref A) and lifted the Temporary Restraining Order (TRO) it had issued July 1. The decision effectively rejected three motions for reconsideration.

**13.** (U) According to Department of Finance (DOF) officials, the amended EVAT law will be implemented on November 1. To address business concerns, the GRP will refine the implementing rules and regulations (IRRs) to provide a more liberal interpretation of the measure capping input VAT credits during any given quarter to 70% of output VAT. Under the revised IRRs, input VAT may be credited in full as long as the input VAT does not exceed the output VAT due. DOF officials expressed confidence that this language would spare the GRP from the tedious process of seeking legislative amendments.

**14.** (U) The GRP did not assume any revenues from the EVAT in its 2005 fiscal program. The incremental revenues during the last two months of 2005 -- estimated at 4-6 billion pesos -- will go to reducing the 2005 fiscal deficit further. The GRP budget expects to generate an additional 80 billion pesos (\$1.4 billion) for the full year in 2006 and will apply this revenue to increase spending on infrastructure and social services while keeping the GRP's fiscal deficit in check and tempering the pace of debt accumulation (Ref B).

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No to Deferment of EVAT on Electricity and Fuel  
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**15.** (SBU) DOF Undersecretary Emmanuel Bonoan -- who shepherded the GRP's centerpiece tax measure through the legislature and helped defend it before the Supreme Court -- downplayed initiatives in both houses of Congress seeking to defer to June 2006 the implementation of the amended EVAT law on the previously exempt petroleum and electricity sectors. U/S Bonoan told econoffs that following mixed signals from the Palace, the chairs of the Ways and Means Committees of both houses of Congress met with President Macapagal-Arroyo to urge her support for implementing the EVAT law in full. According to U/S Bonoan, DOF's marching orders are now clear: a) to implement the EVAT in its entirety; b) to continue to promote a deeper understanding and awareness of the measure and of its importance to longer-term fiscal consolidation and macroeconomic stability; and c) to collect the targeted incremental revenues.

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Financial Markets React Positively

16. (U) The Supreme Court decision elicited some positive reaction from the stock and foreign exchange markets, although concerns over the political backlash, uncertainties over the short-term impacts on inflation and the economy, and some reservations on the GRP's ability to effectively implement the new tax measure may have tempered the optimism. The local currency, which closed at 55.815 pesos/\$ on October 17, strengthened to as high as 55.670 pesos/\$ during afternoon inter-bank trades on October 18 before closing at 55.780. The peso closed at 55.765 on October 19. Stock market trades (which end at noon daily) had closed before the Supreme Court issued its decision in the afternoon of October 18, but closed on October 19 at 1,954.29, up 0.4% from October 18's closing level. Foreign bond markets rewarded the Supreme Court's final ruling with narrower bond spreads. At about mid-afternoon Manila time, spreads on New York trades for Philippine sovereign bonds maturing in 2010 and 2019 and 2025 had narrowed by 9 basis points and for bonds maturing in 2025 by 6 basis points.

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GRP Vows to Monitor Prices Closely...  
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17. (U) The GRP has vowed to monitor prices of basic commodities closely to prevent unscrupulous traders and businessmen from taking advantage of the amended EVAT law to justify significant price increases. The law continues to exempt basic agricultural food products (i.e., rice, corn, fish, vegetables, chicken, pork) from the tax and the Department of Agriculture estimates that potential price increases for such commodities (mainly from higher distribution costs) should not exceed 0.5% when the law goes into effect. Department of Trade and Industry officials estimated that processed food products consumed by low-income groups (i.e., sardines, noodles, milk, cooking oil, etc.) would increase by 2% or less. (Note: Food items make up 50% of the Philippines' consumer price index. End Note.) GRP officials also continue to stress that other vital services will remain exempt from the new tax measure, including low-income rentals and sales of low-cost housing units; educational services; and books, newspapers, magazines. (Refs C-D)

18. (U) Imposing VAT on the previously exempt fuel and electricity sectors at a time of high and volatile world oil prices remains the most politically contentious issue. The Department of Energy (DOE) estimates that the reducing excise taxes, eliminating the franchise tax on power distribution utilities, and lowering tariffs on fuel imports back to 3% should keep petroleum prices from increasing by the full 10% VAT. The DOE expects the cost of diesel to rise by 2.5%, unleaded gas by 8.2%, kerosene by 6.1%, bunker fuel by 6.6%, and liquefied petroleum gas by 7.9%.

19. (U) The Department of Energy is asking the Energy Regulatory Commission to approve revisions in the scheme to discount electricity rates for poor households (i.e., "lifeline rates"). The proposal includes doubling the eligibility threshold for electricity consumption to 200 kwh/month. However, more affluent households (i.e., those consuming more than 1,000 kwh/month) will have to absorb higher electricity rates (roughly 75 centavos/kwh), as will commercial/industrial customers (by roughly 85 centavos/kwh). (Note: Investors here continue to air concerns about high power rates in the Philippines as a competitiveness issue. The country currently has the second highest average electricity rate among ASEAN member countries, after Cambodia. End Note.)

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...While Opposition Lashes Out  
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10. (SBU) While President Arroyo's supporters have by and large supported implementation of the EVAT law, the Opposition has consistently criticized it in the harshest terms. The opposition swiftly condemned the Supreme Court's October 18 decision to lift the temporary restraining order and promised a "national day of protest" in response. Representative Crispin Beltran of leftist Anakpawis party called the tax "blood money," and leftist Bayan Muna Representative Teodoro Casino warned that the Court's decision would "worsen the political situation." Catholic Church Archbishop Oscar V. Cruz, a cleric who leans toward the Opposition, also asserted that the decision would fuel unrest and increase opposition to the Arroyo administration. The Opposition is certain to take this issue to the streets and use it as a rallying point to sustain its efforts -- reflected in its almost daily street protests, which so far remain quite small -- to oust President Arroyo.

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Comment

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¶11. (SBU) The Government has gone on road shows over the past few months to promote a better understanding of the amended EVAT law. The business sector, financial market players, and economists have generally accepted the measure as a bitter fiscal pill that will benefit the economy over the longer-term. Ordinary, non-militant citizens seem resigned although not necessarily accepting of the measure, reflecting disenchantment with corruption, waste, and tax collection inefficiencies. The opposition can be expected to hammer on these weaknesses to continue to embarrass and discredit President Macapagal-Arroyo. Given the fractious political climate and the likelihood of more intense public scrutiny, the challenge for the Administration will be to concretely demonstrate that the short-term pains will indeed redound to longer-term gains. Jones